Estate Planning Insights

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LET'S DISCUSS TRUSTS-PART THREE

Conclusion of Our Discussion of Trusts. We have discussed trusts in our newsletters dated April 30, 2017 and July 31, 2017. In this final newsletter in this series, we will focus on trust income tax matters.

Income Tax Aspects of Trusts. A trust that is currently in effect (as opposed to a trust that will become effective only at some point in the future) is a legally existing entity. As previously discussed, a currently effective trust must have a "corpus," which means that it must own *something* (one or more assets). [A revocable trust may be "unfunded" at the present time, although, technically, it should own at least $1 (so that it has a corpus).] A trust may own real estate, stocks, bonds, mutual funds, money market accounts, CDs, a life insurance policy, an interest in a closely held business, or virtually any other asset. Most (but not all) assets owned by the trust will produce or earn income. In fact, one of the duties of a Trustee is to make the trust assets "productive"–i.e., produce income (although sometimes a trust asset is held for long-term growth, rather than to produce current income). The bottom line is that income taxes are not avoided by placing assets in a trust. Every year, the trust assets will earn income and that income will be brand new income that no one has ever paid income taxes on before–*someone* will pay income taxes on that income.

The particular income tax aspects of a trust depend on the "classification" of the trust for federal income tax purposes. Since Texas does not have a state income tax that applies to trusts, we will be focusing solely on the federal income tax rules. Our intent is to discuss basic principles and not highly technical matters or exceptions to the usual rules. We are simply trying to provide *general information* regarding the income taxation of trusts and their beneficiaries (because there seems to be a lot of misunderstanding in regard to trust income tax matters). We always recommend that our clients who are Trustees hire a knowledgeable CPA to prepare all necessary trust income tax returns.

Income Tax Aspects of Revocable Trusts. The income tax aspects of revocable trusts (sometimes called "living trusts") are relatively simple. A revocable trust is considered a "grantor type trust" for federal income tax purposes (we will just use the term "grantor trust"). When a trust is a *grantor trust*, it means that all income, deductions, credits, etc. of the trust are reportable by the Grantor (creator of the trust) in the Grantor's federal income tax return (Form 1040). A grantor trust is not an income tax-paying entity.

If the Grantor is also the sole Trustee of his revocable trust, no separate taxpayer identification number (also called an "employer identification number" or "EIN") is required for the trust. The Grantor's Social Security Number applies to the trust. In addition, no separate tax return must be filed for the trust in that case.

In the case of a joint revocable trust created by a married couple, if community property is placed in the trust, each spouse is treated as the grantor as to ½ of the trust. If the spouses are Co-Trustees of the trust, no separate EIN must be obtained for the trust and no separate income tax return must be filed for the trust.

Sometimes the Grantor loses her mental capacity and another person takes over as Trustee of her revocable trust. Note that, as long as the Grantor is living and the trust remains revocable, the trust is still a grantor trust for federal income tax purposes even if the Grantor is no longer serving as Trustee. Sometimes the Grantor appoints a bank or trust company as Trustee of her revocable trust from the beginning. In the case where someone other than the Grantor is serving as Trustee of the trust, the Trustee will often obtain an EIN for the trust. Even so, the grantor trust is still not a taxable entity. However, if someone other than the Grantor is serving as Trustee, that Trustee may file an "information-type return" for the grantor trust (Form 1041), indicating that the trust is a grantor trust and that all income, deductions, credits, etc. will be reported by the grantor in her individual tax return (Form 1040). There are some other reporting options in this situation as well.

Bottom Line: A revocable trust is a grantor trust for federal income tax purposes and does not pay income taxes on its income–the Grantor does.

Income Tax Aspects of Irrevocable Trusts. There are many different types of *irrevocable* trusts, but we are going to focus on the most common types of *personal* trusts (we will not discuss charitable trusts or other specialized types of trusts in this newsletter). When it comes to federal income taxes, *irrevocable* trusts are primarily categorized as one of three types:

1. Simple Trust.
2. Complex Trust.
3. Grantor Trust.

But wait! We just explained that *revocable* trusts are grantor trusts. It is true that revocable trusts are grantor trusts, but *some* specially designed irrevocable trusts are grantor trusts, too. We will get to that later.

Trust Income. *Income* is construed differently depending on the context. For fiduciary accounting purposes, the Trustee must allocate receipts to income or principal or partly to each (e.g., rent and royalties can be treated as part income and part principal due to depreciation/depletion reserves). Expenses must also be allocated between income and principal. Texas' Uniform Principal and Income Act ("UPIA") contains "default rules" that allocate receipts and disbursements between trust income and principal. Note that the instrument that creates the trust can override the UPIA "default rules" and provide its own allocation rules.

We have previously noted that the assets of the trust are the principal (or corpus) of the trust. Income is the "fruit" produced by the principal. Thus, for example, if the trust owns common stock and receives dividends on that stock, those dividends are income.

Different rules apply to *income* in the income tax context. With respect to trust income tax matters, *income* usually refers to "ordinary income," such as interest, dividends, rent, royalties, etc., and does not usually include capital gains. Consider what a capital gain represents. When an asset of the trust, such as land, is sold, the cash that is received on that sale represents a change in the form of principal (i.e., from land to cash). If the amount of cash received on the sale exceeds the "tax basis" of the land, that triggers a capital gain. The capital gain represents growth in the value of the asset (principal) over time. So, a capital gain is not really the same as income (it is not a "fruit" of principal–it is part of principal).

Despite the above, some instruments that create a trust (e.g., a Will or Trust Agreement) provide that capital gains are to be treated as income. In addition, even if the trust instrument does not provide that capital gains are treated as income, there are situations where it is possible (and desirable) to treat capital gains as income (that topic is beyond the scope of this newsletter).

Trust Income Tax Return. As a general rule, an irrevocable trust must use the calendar year as its tax year. Therefore, the income tax return for an irrevocable trust will be due on April 15 each year (unless the due date is extended). An irrevocable trust almost always has its own EIN. The income tax return that is filed for the types of trusts we are discussing is a Form 1041, U.S. Income Tax Return for Estates and Trusts. If any income was distributed out of the trust to a beneficiary during the year, the beneficiary will receive a K-1 from the Trustee, indicating the amount and type of income he received from the trust during the year. The information in the beneficiary's K-1 will carry over to the beneficiary's individual income tax return (Form 1040).

Simple Trusts. A trust that mandates (requires) the Trustee to distribute all of its income to the beneficiary each year is classified as a "simple trust" for federal income tax purposes. In other words, if the provisions in the instrument that created the trust clearly state that all income of the trust must be distributed out of the trust to the beneficiary each year, the trust is a *simple trust*. Typical simple trusts are Marital Trusts (such as QTIP Trusts) and QSSTs (Qualified Subchapter S Trusts).

In the case of a simple trust, the Trustee is not going to distribute the *gross* income of the trust to the beneficiary. The gross income is the total income received by the trust, prior to the payment of trust expenses. Instead, the Trustee is going to distribute the *net* income of the trust (the trust's gross income minus expenses properly payable by the trust and chargeable to income).

As noted, in the case of a simple trust, the net income of the trust is distributed out of the trust to the beneficiary each year. Thus, a simple trust will not pay income tax on that income because that income will "end up with" the beneficiary. The beneficiary will pay income taxes on that income (which is "fair" because the beneficiary received that income). That income will have the same "character" in the hands of the beneficiary that it had when received by the trust. Thus, if the trust's income consisted of 30% ordinary dividends, 60% qualified dividends and 10% interest, the income received by the beneficiary will be of the same character.

Bottom Line: A simple trust does not pay income taxes on its (net) ordinary income–the beneficiary does.

Complex Trusts. A *complex trust* is an irrevocable trust in which the trust instrument gives the Trustee *discretion* whether to distribute out of the trust (to one or more permissible beneficiaries) or retain inside the trust the income earned by the trust assets each year. The Trustee of a complex trust may vary his income distribution decision from year to year. The taxation of the income earned by a complex trust depends on the Trustee's distribution decisions. Typical trusts that are drafted as complex trusts include Bypass Trusts and Descendant's Trusts (lifetime trusts for descendants).

Unlike simple trusts, complex trusts may need to make quarterly estimated tax payments due to the possibility that all or part of trust income may be retained in the trust. Complex trusts have 5 tax brackets (15%, 25%, 28%, 33% and 39.6%), but the brackets are "compressed" compared to the individual tax brackets. In other words, a complex trust will reach the highest tax bracket much more quickly than individuals. In 2017, a complex reaches the 39.6% tax bracket once it earns $12,500 in annual income. In contrast, married couples who file jointly do not reach the 39.6% federal tax bracket until they have $470,700 in annual income and single individuals do not reach the 39.6% federal tax bracket until they have $418,400 in annual income. In addition, complex trusts are subject to the 3.8% net investment income tax ("NIIT") on net investment income. In 2017, complex trusts start paying the additional 3.8% NIIT at a threshold of $12,500. In contrast, married couples do not start paying the 3.8% NIIT until they reach $250,000 in annual income and single individuals do not start paying the 3.8% NIIT until they reach $200,000 in annual income. Thus, a complex trust can have a combined federal income tax rate of 43.4% (39.6% + 3.8%) on retained income starting at $12,500 (2017 figure).

The above tax rate discussion ignores qualified dividends and long term capital gains. If a complex trust receives qualified dividends and/or long term capital gains, the tax rate on those items is 20% once the $12,500 threshold is reached.

If a complex trust retains its income in a particular year, then the trust, and not the beneficiaries, will pay the income taxes on that retained income. As noted, retained trust income can be taxed at a very high rate, starting at a very low threshold. To the extent the Trustee makes a distribution of trust income out of the complex trust to a permissible beneficiary of the trust, that distribution will carry out the "distributable net income" ("DNI") of the trust to the beneficiary. This means that the beneficiary, and not the trust, will pay income taxes on that distributed net income. In fact, the trust will receive a deduction in its tax return for that distribution. Thus, there is not a "double tax" on trust income–it's an "either/or" situation. If DNI is distributed to multiple permissible beneficiaries of the trust, each recipient of any portion of that DNI will be responsible for paying income taxes on the share he/she received in his/her own income tax bracket.

The Trustee must deliver K-1s to each beneficiary who receives a distribution from the trust. Just as with a simple trust, the income distributed out of the complex trust retains its character in the hands of the beneficiaries. If any of the permissible beneficiaries of a complex trust are in lower income tax brackets than the trust itself, *assuming the trust distribution standard would permit the Trustee to make distributions to those beneficiaries*, it often makes sense for the Trustee to make distributions of trust income out of the trust to the beneficiaries. That will carry out the trust's income to the beneficiaries, to be taxed in their respective lower tax brackets–a better choice (from a pure income tax standpoint) than retaining that income in the trust, where it would be taxed at a high rate. Note that *ordinary income* earned by the trust assets is deemed to be distributed prior to the principal of the trust. This "ordering rule" precludes taking the position that the distribution was a distribution of principal (and, therefore, not taxable) in cases where the trust has undistributed income.

Bottom Line: The income of a complex trust is taxed based on the Trustee's distribution decisions. Income retained in the trust is taxed to the trust, while income distributed to one or more permissible beneficiaries is taxed to the recipients in their respective tax brackets.

Irrevocable Grantor Trust. A grantor may create an *irrevocable* trust for the benefit of other persons (such as children) and design the trust to be a *grantor trust* for federal income tax purposes as to himself. The gift of assets made by the grantor to the trust should be a *completed gift* for federal gift (and estate) tax purposes, which should result in those assets being excluded from the grantor's estate at death. However, the grantor will still be taxable on the income earned by the trust assets as long as the trust remains a grantor trust for income tax purposes.

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Why do this? One study indicates that this is one of the most effective "wealth transfer" techniques. So long as the trust is a *grantor trust*, the grantor must pay income taxes on the income earned by the trust assets. Thus, each time the grantor pays "the trust's" income taxes, it is as if the grantor were making additional gifts to the trust (and its beneficiaries). Fortunately, a federal tax ruling indicates that these tax payments are *not* treated as gifts under the gift tax laws. Thus, no gift tax exemption must be used. In addition, the payment of income taxes on "the trust's" income reduces the grantor's estate for federal estate tax purposes. Further, as long as the trust remains a grantor trust, the grantor may sell assets to the trust and that transaction is not treated as a taxable sale or exchange. The grantor could sell assets to the trust that are likely to appreciate in value in the future. At the time of sale, the trust will pay fair market value to purchase those assets, giving the grantor a cash down payment and a note for the balance of the purchase price. The terms of the transaction should be "commercially reasonable" and the note should be structured to meet federal tax requirements, including bearing interest at the Applicable Federal Rate. All post-sale appreciation in the value of the assets sold to the trust inures to the benefit of the trust and its beneficiaries (and is outside the grantor's estate for federal estate tax purposes). This summary is an "over-simplification," but, hopefully, it has explained that an *irrevocable* trust can sometimes be a grantor trust, too, and why a grantor might use this technique.

Conclusion. We hope our three newsletters discussing trusts have been helpful to you. As you can tell, we love trusts and the benefits they provide! Trusts are very useful in estate planning for many reasons.

In January, we are planning to discuss recent state law changes (and federal tax law changes, if any).

Thank you for your business and your referrals this year. We appreciate you and your referrals very much.

As the holidays approach, we want to wish you and yours Happy Holidays!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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